CAPITAL PROJECTS AND BOND OVERSIGHT COMMITTEE

August 15, 2000

The Capital Projects and Bond Oversight Committee met on Tuesday, August 15, 2000 at 1:00 p.m., in Room 129 of the Capitol Annex. Representative Jodie Haydon, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Representative Jodie Haydon, Chairman; Senators Tom Buford and Bob Jackson; and Representatives Robert Damron, Paul Marcotte, and Jim Wayne.

Guests testifying before the Committee: Secretary John McCarty, Commissioner Armond Russ and Jim Abbott, Finance and Administration Cabinet; John Lile, Kentucky State Police; Warren Nash, Economic Development Cabinet; Roger Recktenwald, Kentucky Infrastructure Authority; Chris Zimmer, Norton Healthcare; Charles Lee, Salomon Smith Barney; Kevin Hable, Wyatt, Tarrant & Combs; Mike Herrington, Stites & Harbison; and Tom Howard, Office of Financial Management.

LRC Staff: Mary Lynn Collins, Pat Ingram, Kevin Mason, Lola Williamson Lyle, Lou Pierce, and Shawn Bowen.

Representative Damron made a motion to approve the minutes of the July 13, 2000 meeting as submitted. The motion was seconded by Representative Marcotte and passed by voice vote.

Chairman Haydon called on Ms. Mary Lynn Collins, Capital Projects and Bond Oversight Committee Staff Administrator, to review various correspondence and information.

She also provided a follow-up report to questions raised at the Committee's July meeting regarding the Parks Capital Maintenance and Renovation Fund, and noted that the Finance and Administration Cabinet Secretary recently reported that there was enough undesignated fund balance in the General Fund at the close of the last fiscal year to fully fund the Surplus Expenditure Plan. She said that means the Emergency Fund will receive an additional $4.5 million, the Contingency Fund will receive an additional $5.5 million, and the Budget Reserve Trust Fund will receive $39.3 million.

Chairman Haydon said last month there was a request for more discussion on the Management Agreement that is to be used in the transfer of Western Kentucky University's housing assets to the WKU Student Life Foundation. He said in order to have all the key players in the development of this agreement present, that discussion has been delayed until the Committee's September meeting.

Chairman Haydon introduced Finance and Administration Cabinet Secretary John McCarty and Commissioner Armond Russ, Department for Facilities Management, to discuss a project report submitted by the Finance and Administration Cabinet.

Secretary McCarty first reported a $27,500 cost overrun for the Northern Kentucky University Landrum Hall Structural Safety Repairs project. This project was authorized by the 1998 General Assembly at a scope of $650,000 in restricted funds, and in April 2000, the Committee reviewed an emergency action to increase the scope of the project by $70,000. Secretary McCarty said Deferred Maintenance/Government Mandates Bond Pool funds will be used to fund this latest emergency scope increase. The revised project scope is $747,500.

Secretary McCarty next reported a $425,000 cost overrun for the state police post in Henry County. The project was authorized by the 1998 General Assembly at a scope of $1,200,000 in bond funds. He said the scope increase will be funded with $245,000 in federal asset forfeiture funds and $180,000 in agency funds, and is required to meet the low construction bid.

Representative Wayne asked why the architect's cost estimate for construction was off by 44%. He asked if they expect to have similar funding problems with the Hazard State Police Post since the same design is being used. Commissioner Russ said there were land acquisition costs associated with this project that are not associated with the Hazard project.

Representative Damron asked if the Finance and Administration Cabinet reviewed the estimated project costs to determine why the architect's estimate was off by 44%. Commissioner Russ said they realized when the project was bid, it would come in over the cost estimate. He explained that after value engineering, the agency decided it could make no further reductions, and they asked the Finance Cabinet to proceed with the bids.

In response to a question from Representative Damron, Commissioner Russ said his department reviewed the original cost estimates presented to the 1998 General Assembly, but the accuracy of those estimates are based on a number of variables. He said the Division of Engineering plans to work more closely with agencies on project cost estimates in advance of presentations to the General Assembly in order to improve the cost estimates.

Representative Damron asked where the federal funds for this project would be used if they were not used for the state police post. Colonel John Lile, Kentucky State Police, said those moneys would normally be used to buy evidence to arrest drug dealers and to purchase equipment for drug enforcement activities. He said purchase of the equipment can be delayed, but the post is a priority for the State Police.

In response to another question from Representative Damron, Colonel Lile said the money is not being taken away from any other programs that are needed at this time.

Senator Buford made a motion to approve the cost overrun for the LaGrange State Police Post in Henry County. The motion was seconded by Representative Damron and passed by voice vote. The revised project scope is $1,625,000.

Secretary McCarty reported a $300,000 federally funded scope increase for the Kentucky State Police system known as Collision Report Analysis for Safer Highways (CRASH). This project was authorized by the 1998 General Assembly at a scope of $2,500,000 ($1,587,000 bond funds and $913,000 federal funds). Secretary McCarty said the additional funds will allow completion of the system's Phase III and provide funding for Phase IV as well.

In response to a question from Representative Damron, Secretary McCarty said the funding source for this project is federal Highway Traffic Safety Funds.

Representative Damron made a motion to approve the scope increase for CRASH. The motion was seconded by Senator Buford and passed by voice vote. The revised project scope is $2,800,000.

Secretary McCarty next discussed a $200,000 federally funded cost overrun for the Department of Juvenile Justice Secure Juvenile Detention Center project in Laurel County. This project was authorized by the 1998 General Assembly at $5,357,000 (bond funds), and the Committee approved last April an additional $92,000 from the Contingency Fund for the project. Secretary McCarty said the funds to cover the cost overrun will come from the federal Juvenile Accountability Block Grant program. The funds will be used to correct unforeseen conditions at the site.

Senator Buford made a motion to approve the cost overrun for the juvenile detention center project. The motion was seconded by Senator Jackson and passed by voice vote. The revised project scope is $5,649,000.

Lastly, Secretary McCarty reported two land acquisitions for the Department of Fish and Wildlife Resources: the Huston Property in Fleming County for $763,383

(Kentucky Heritage Land Conservation Fund allocation), and Latourneau Woods in Fulton County for $2,135,500 (Kentucky Heritage Land Conservation Fund allocation and other fund sources). Chairman Haydon said no action was necessary for the two projects.

Secretary McCarty then discussed the Surplus Expenditure Plan. He said as noted earlier, $39 million in the budget surplus was placed in the Budget Reserve Trust Fund, bringing the balance to approximately $279 million, its highest level in history. He added that the capital program over the next two years is extremely aggressive and the status of the Budget Reserve Trust Fund will be important to the investment community when bonds to finance part of the capital program are marketed. He said from a financial perspective, the state is in good shape.

Chairman Haydon thanked Secretary McCarty for his presentation. He then introduced Mr. Jim Abbott, Director, Division of Real Properties, to discuss two lease reports.

Mr. Abbott reported eight state agency leases which have been modified to increase or decrease the amount of space leased. He also reported two state leases that were transferred to other state agencies. Chairman Haydon said no action was required for these lease modifications.

Mr. Abbott next discussed a lease renewal contract for property in Franklin County: PR-4232, Justice Cabinet, Department of Juvenile Justice. He said the lessor is Capital Complex East and the lease is being renewed for five years at an annual cost of $184,889. The lease rate has been increased from $8.30 per SF to $9.75 per SF, and the space has increased from 17,784 SF to 18,963 SF to include certain common space. He said when the state first acquired the lease in the building, common space was not included because the agency did not at that time occupy the entire floor which it does now. He said pursuant to KRS 56.806 the state pays for the hall space and the bathrooms, but not the stairwells. (KRS 56.806 requires payment for common space when the state is the only tenant on a single floor of a multistory building.)

In response to a question from Senator Buford, Mr. Abbott said the Division of Real Properties has visited Capital Complex East and it is completely occupied by state agencies.

Mr. Abbott said there were three bidders for this lease project, but two withdrew which left a non-competitive bid situation. Senator Buford asked why the two potential lessors withdrew from the competitive bid process. Mr. Abbott said both bidders were offering new construction and they felt like they were not in a competitive bid situation where they could compete with existing construction. However, he added that one of the bidders who withdrew initially submitted a rate close to the new rate now being processed.

Representative Wayne made a motion to approve the lease renewal for PR-4232, Justice Cabinet, Juvenile Justice. The motion was seconded by Senator Jackson and passed by voice vote.

Next, Mr. Roger Recktenwald, Executive Director for the Kentucky Infrastructure Authority (KIA), presented four new KIA projects:

1) A $997,734 KIA Fund A (Federally Assisted Wastewater Revolving Loan Fund) loan for the Mountain Water District, Pike County. The loan will be used to expand the sewer facility. The terms of the loan are 3.8% for 20 years.

2) A Fund A loan for the City of Wurtland, Greenup County. The loan will be used to correct severe corrosion at the wastewater treatment plant. The terms of the loan are 3.8% for 20 years.

3) A $1,500,000 Fund F (Federally Assisted Drinking Water Revolving Loan Fund) loan for the City of Princeton, Caldwell County. The loan will be used to upgrade and expand the city’s water treatment plant. The terms of the loan are 3.8% for 20 years.

4) A Fund F loan for the City of Hardinsburg, Breckinridge County. The loan will be used to expand the city's water treatment plant. The terms of the loan are 1.8% for 20 years.

Mr. Recktenwald said the engineering fees associated with the City of Wurtland project were high because of two additional engineering services required for this project: an additional sewer system evaluation survey was performed and a survey conducted dealing with the corrosive nature of the inflow to this plant.

Senator Buford said it was alarming to see the ratio of engineering fees to construction costs at 30% for this project. Mr. Recktenwald acknowledged this caused considerable concern for them as well and the Division of Water was asked to review the project. Based on that review, the staff of KIA and the Division of Water feel that even though the costs are significant, they are warranted under the circumstances. Mr. Recktenwald said PDR is the engineering firm for the project and US Filter is also assisting with the project.

Senator Jackson made a motion to approve the four new KIA loans. The motion was seconded by Representative Wayne and passed by voice vote.

Chairman Haydon then welcomed Mr. Warren Nash, Director, Grant Programs Division, Economic Development Cabinet, who recently replaced Mr. David Bratcher upon his retirement. Mr. Nash reported three line-item Economic Development Bond Pool projects approved by the 2000 General Assembly under House Bill 502: Grayson Lake Golf Course Development project ($4,500,000); Blue Licks Lodge Food Service Expansions/Daniel Boone Cabin Preservation project ($750,000); and the Tourism Development Loan Program ($1,500,000). Mr. Nash said under a Memorandum of Agreement (MOA), the Department of Parks will administer the Grayson Lake Golf Course Development project and the Blue Licks Lodge Food Service Expansions/Daniel Boone Cabin Preservation project. He said an MOA is being negotiated for the Tourism Cabinet to administer the Tourism Development Loan Program.

Mr. Nash said also enclosed in members' folders was a letter from Mr. Bratcher in response to questions raised by the Committee at its July meeting regarding several Economic Development Bond projects.

Next, Mr. Tom Howard, Office of Financial Management, reported six items for the Committee’s consideration. He first reported a new conduit bond issue - Kentucky Economic Development Finance Authority (KEDFA) Health System Revenue Bonds, Series 2000 for Norton Healthcare, Inc. in the amount of $476,201,212. He said this bond issue is a cashflow financing for Norton Healthcare and is not an obligation to the Commonwealth. Mr. Howard then introduced Mr. Chris Zimmer, Chief Financial Officer, Norton Healthcare; Mr. Charles Lee, Underwriter, Salomon Smith Barney; Mr. Kevin Hable, Bond Counsel, Wyatt, Tarrant & Combs; and Mr. Mike Herrington (representing KEDFA), Stites & Harbison, to answer questions regarding this bond issue.

Chairman Haydon said statements which were faxed to the Committee the day before the meeting from Norton Healthcare and from the American Federation of the State, County, and Municipal Employees (AFSCME) had been distributed to the members.

Representative Wayne asked if it is normal for the Committee to review KEDFA bond issues before KEDFA has given its final approval. Mr. Howard said it depends on the timing of the KEDFA meetings. In this case, the Norton Healthcare bond issue has only received preliminary approval from KEDFA. He said sometimes these bond issues come before the Committee prior to a final review by KEDFA.

In response to another question from Representative Wayne, Mr. Howard said it is at the request of the Cabinet for Economic Development that the Committee is being asked to review these bonds before the public hearing (sponsored by KEDFA) and before KEDFA's final review.

Representative Wayne asked if Norton Healthcare was in a rush to issue these bonds. Mr. Hable explained that if this transaction is closed in early to mid-September, the system will not be required to make a $ 10 million debt service payment scheduled for October 1.

Representative Wayne said over the long run the bonds are being financed at 6.585% and the current financing is at a lesser interest rate. He said according to his information, this bond issue will cost Norton $210 million more in the long run. He asked if this was accurate. Mr. Zimmer said it is an accurate statement in terms of raw numbers, but the statement does not recognize the time value of money.

Representative Wayne asked if they had considered selling some of their assets to improve their cashflow. Mr. Hable said the assets - Kosair Children's Hospital, the partnership with the University Hospital, and the former Columbia Hospitals - enable the system to provide convenient hospital care for every resident of Jefferson County regardless of the part of the county in which he or she lives. He said maintaining those assets is an important part of maintaining the overall mission of the hospital.

Representative Wayne said he appreciated Mr. Hable's comments and he agreed the services Norton provides are excellent. He said it appears that Norton's Board of Trustees has made a decision that will cost the hospital system $210 million more to free up capital now to sustain the hospital's current quality.

Representative Wayne asked if Norton plans to refinance this bond issue when they have to start paying the principal in 2006. Mr. Hable said every Norton debt financing since the 1980s has been refinanced, refunded, or restructured within a five-year period from the initial date of issuance. He said the objective is not to cost the system more money, but to free up money in the short-run that can be put to immediate productive use and keep Norton's options open to restructure the debt at an appropriate time.

Mr. Zimmer said the primary motivations of this transaction are flexibility and good stewardship. He said the cashflow savings in the early period will allow Norton to strengthen its balance sheet and increase its flexibility and weather the storm that the entire health care industry is going through. Mr. Zimmer assured the Committee that Norton Healthcare is solid and financially stable as evidenced by ratings from the bond rating agencies. He said while there is no specific plan to refinance within five years, it is an option.

Mr. Hable said MBIA, the largest and leading bond insurance company in the U.S., has reviewed the transaction and has committed to insuring approximately one-half of the bonds. Mr. Hable said they have had some preliminary discussions with one of the bond rating agencies, and they expect the bonds to carry investment grade ratings. The insured portion will have a AAA rating and the uninsured portion will likely be rated A-. Mr. Hable said there have been other groups beyond the Norton Healthcare Board that have reviewed the bond issue and see the issue as a sound and safe financing plan.

Representative Wayne said this is a major bond issue, and questioned whether the Committee should delay action until after the public hearings are conducted and until KEDFA has taken final action. He said that Norton Healthcare is a very important health care network in Jefferson County, and the Committee should make sure this is a solid financial transaction.

Senator Buford asked if there is a letter of credit or a letter of security backing the uninsured portion of the bond issue ($250 million). Mr. Lee said other than the MBIA insured bonds, there are no credit enhancements. He said the bonds will stand based on the credit quality of Norton Healthcare alone, which is an A- rating.

Senator Buford asked if Norton will assist the employees of Columbia Hospitals to recover retirement funds from the 401K plan that were lost when the hospitals were sold to Norton. Mr. Hable said Norton does not have a legal obligation to make 401K contributions for prior periods, nor can it do so without creating tax problems for Norton Healthcare and the employees into whose accounts the payments would have been made. He said in several other instances Norton did make a financial contribution or other changes in its benefit plans to accommodate onerous conditions created in the transition. In addition, he said Norton also made a commitment to Columbia employees that if any of them chose to pursue legal remedies against Columbia, regarding the 401K issue, Norton would help defray the cost of that legal representation. He said to his knowledge, none of the employees have done this yet.

Senator Buford asked if Norton plans to lay people off. Mr. Hable said from September 1, 1998 to present, the system has added several hundred employees. He said the refinancing will enable them to preserve these gains in the workforce.

Representative Marcotte said he was prepared to support this bond issue today because Carroll County Community Hospital, which is in his district, considers this bond issue very important to its continued operation. He said he hoped Norton would be able to remain independent and not become a candidate for merger in the future.

Senator Jackson asked why Norton Healthcare is using KEDFA as a conduit to issue its bonds instead of Jefferson County. Mr. Hable said to accomplish this refinancing, Norton would have needed to proceed through both Jefferson and Marion Counties. He said they did this in 1998, but now, rather than proceed in two or three different jurisdictions, they requested KEDFA to be the conduit issuer.

In response to questions from Senator Jackson, Mr. Zimmer said the total cost of the transaction is approximately $16 million; this includes the insurance and underwriting fees, as well as administrative and legal costs of printing. Mr. Zimmer said all costs of issuance are included in the present value calculation of the cost.

Senator Jackson asked for what the new money portion of the bond issue (up to $25 million) would be used. Mr. Hable said the new money will be used for capital improvements at all the hospitals. However, depending on market conditions, they may not issue the $25 million in new money.

In response to a question from Senator Jackson, Mr. Zimmer said Norton currently has $17 million in debt service reserve for current bonds outstanding. Mr. Lee said the debt service reserve will be increased to $47.6 million, which reflects the more current standard of having one year of average annual debt service requirement in reserve.

Senator Jackson asked about the amount of old bonds that will be replaced. Mr. Lee said approximately $410 million in old bonds will be replaced because the bonds are being refinanced at a higher interest rate. He referred the Committee to Exhibit B of the KEDFA bond information form. Chairman Haydon said the Committee did not receive Exhibit B, and asked that copies of the document be distributed to the Committee.

Senator Jackson said this is a major transaction and normally the Committee has no jurisdiction or statutory authority over these types of issues, but Norton chose to use KEDFA, which put the issue in the Committee's jurisdiction.

Representative Damron said he agreed with Senator Jackson that Norton has a Board of Directors and can normally make their own decisions of how to do business; however, they crossed over the threshold by asking the state to use its municipal standing to get a preferred rating on its bond issue. He said this opened Norton up to questions about the public trust. He said Representative Wayne's questions were appropriate since the state has a responsibility for health care and pays for indigent health care.

Representative Damron asked if Norton will pay any penalties to refinance the current bond issue. Mr. Lee said no penalties will be paid since the bonds are not being called early.

Representative Damron asked if Norton Healthcare has considered the option of issuing short-term bond anticipation notes. Mr. Lee said that they have looked at different alternatives to achieve the same goals, including a partial refunding of the debt, but the alternatives do not create the same type of flexibility or the same type of cashflow savings the organization is seeking. He said he did not think Norton could use bond anticipation notes with KEDFA involved.

Mr. Hable said that Norton is not in a cashflow problem that would cause it to have problems with paying off the debt that now exists, and Norton has the financial ability to pay all its outstanding debt as it is on the books now. Mr. Zimmer added that should Norton not complete this transaction by September, the cash is available and the debt service will be met.

In response to a question from Representative Damron, Mr. Hable responded that all requirements have been met and they have adequate insurance coverage. As a condition to these bonds closing, the bond counsel's firm will be asked to give a number of legal opinions to the bondholders for the public record.

Representative Damron asked why Norton was using out of state firms to complete the bond issue. Mr. Zimmer said they used Salomon Smith Barney as the lead investment banker because of the company's experience on a national basis. He added that there will be significant local involvement in the bond issue, including Hilliard Lyons, Fifth-Third Bank and PNC Bank, as well as others from Kentucky.

Representative Wayne said he has some serious concerns regarding this bond issue, considering the recent history in Louisville with health care industries such as Columbia Hospital and Vencor. He said this bond issue has not gone through the full KEDFA process and that Norton seemed to be in a panic to issue these bonds, and he would feel more comfortable reviewing this bond issue after KEDFA's final decision and after Committee staff has had time to review handouts distributed today.

Representative Wayne made a motion to pass over the KEDFA bond issue for Norton Healthcare until the Committee's September meeting. The motion was seconded by Senator Buford.

Mr. Hable asked if he could address the Committee. He said there is no panic on the part of Norton to issue the bonds, and if this refinancing is not approved, Norton will go forward. He said it is a question of Norton being able to take advantage of opportunities that it has before it to integrate facilities that it bought and converted to community assets two years ago. He said Norton's ability to go forward in a timely manner depends on the Committee's considering and approving this bond issue. Mr. Hable said they thought it was important to try and stick with this timetable because this timetable will not only allow Norton to achieve a savings over the next five years of $80-$100 million, but it will also allow the system to save as of October 1, approximately $10 million in debt service payments.

Representative Damron said he was not going to support Representative Wayne's motion to pass over the KEDFA bond issue for Norton Healthcare. He explained that he did not necessarily think the bond issue was a good deal, but Norton Healthcare has an independent operating board, and they have made the decision that this is the direction in which they want to go. He said he was concerned that government is putting itself in a position of making a decision on the financing for a corporation that has already made this decision.

Representative Wayne said the way the system is set up, Norton has applied to issue bonds through the state, and as part of that system, they must go through this process. He said since the Committee does not have all of the information regarding the bond issue, KEDFA has not finished its own analysis, and because of the current health care climate, this bond issue should be postponed for one month.

Senator Buford said by voting today, the Committee is pre-empting KEDFA.

Chairman Haydon asked for a roll call vote on the motion. A roll call vote was taken, and the motion was lost.

Senator Jackson said he voted against the motion to pass over the bond issue because there are no state moneys involved as he initially thought there might be. He said because some of this information regarding Norton was received just prior to the meeting, Norton's case was not made very well.

Representative Damron made a motion to approve the KEDFA bond issue for Norton Healthcare subject to KEDFA's final review and approval after all due diligence is taken and all statutory requirements are met. The motion was seconded by Representative Marcotte and passed by voice vote.

Mr. Howard next reported KEDFA Revenue Bonds, 2000 Series for Pikeville United Methodist Hospital of Kentucky, Inc. for $10,000,000.

In response to a question from Representative Wayne, Mr. Nash said that KEDFA had not approved this bond issue yet.

In response to a question from Senator Jackson, Mr. Howard said this bond issue is also a conduit bond issue and no state moneys are involved.

Senator Jackson made a motion to approve the KEDFA Revenue Bonds, 2000 Series for Pikeville United Methodist Hospital of Kentucky contingent upon final KEDFA loan approval. The motion was seconded by Representative Damron and passed by voice vote.

Mr. Howard reported a new bond issue for Kentucky Housing Corporation (KHC) Housing Revenue Bonds, 2000 Series E, F, & G, for $90,000,000.

Representative Marcotte asked why there was such a difference between the interest rates for Series E, F, and G bonds. Mr. Howard said it was the tax status of the bonds. He explained that the Series E bonds are fully tax-exempt, while the Series F bonds are partially tax-exempt and subject to the alternative minimum tax, and the Series G bonds are fully taxable.

Representative Wayne made a motion to approve the new bond issue for KHC Housing Revenue Bonds, Series 2000. The motion was seconded by Senator Buford and passed by voice vote.

Mr. Howard then reported a new bond issue for Kentucky State Property and Buildings Revenue Bonds, Project No. 67, in an amount not to exceed $135,000,000.

Senator Buford made a motion to approve the new bond issue. The motion was seconded by Senator Jackson and passed by voice vote.

Mr. Howard presented an approval letter for Kentucky Asset Liability Commission General Fund Tax and Revenue Anticipation Notes, 2000 Series A. Chairman Haydon said no action was required for this follow-up report.

Lastly, Mr. Howard reported five new bond issues with School Facilities Construction Commission (SFCC) debt service participation: Corbin Independent (Whitley Co.); Madison County; McCreary County; Owen County; and Rockcastle County.

Senator Jackson made a motion to approve the school bond issues with SFCC debt service participation. The motion was seconded by Representative Marcotte and passed by voice vote. Representative Damron abstained from the vote, citing a potential conflict of interest.

Chairman Haydon said there were also five locally funded school bond issues submitted to the Committee for review this month: Crittenden County; Kenton County; Lyon County; Pulaski County; and Scott County. He said all disclosure information has been filed and no further action on these bond issues is required.

Chairman Haydon said the Committee's next meeting is scheduled for Tuesday, September 19, 2000 at 1:00 p.m. in Room 129 of the Annex.

With there being no further business, Representative Damron made a motion to adjourn the meeting. The motion was seconded by Senator Buford and passed by voice vote. The meeting adjourned at 3:00 p.m.